In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 73-1754

INTERNATIONAL SHOE MACHINE CORPORATION,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum of decision of the district court (Pet. App. B 20-30) is reported at 369 F. Supp. 588. The opinion of the court of appeals (Pet. App. C 31-36) is reported at 491 F. 2d 157. The memorandum and order of the court of appeals on petition for rehearing (Pet. App. E 38-39) is not reported.

JURISDICTION

The judgment of the court of appeals (Pet. App. D 37) was entered on January 23, 1974. A petition for rehearing was denied on February 25, 1974. The petition for a writ of certiorari was filed on May 23, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the gain realized from the sale of shoe machinery manufactured by petitioner and previously leased to customers was taxable as ordinary income, as the decision below held, and not as long-term capital gain.

STATUTE INVOLVED

Section 1231 of the Internal Revenue Code of 1954 is set forth at Pet. App. A 18-19.

STATEMENT

Petitioner is a manufacturer of shoe machinery. During the years in issue, 1964 through 1966, it sold a number of machines previously leased by it and reported the gain therefrom as long-term capital gain under Section 1231 of the Internal Revenue Code. The propriety of capital gain treatment is the sole issue raised in the petition.

The pertinent facts are as follows: Petitioner's main source of business income was derived from leasing its shoe machinery equipment to shoe manufacturers. However, during the years in issue, petitioner sold a total of 271 machines, realizing a gain therefrom in the total amount of $660,420.94 (Pet. App. B 20). Petitioner's volume of sales in the years in issue represents a dramatic increase over sales in the preceding years, although sales revenues comprised only 7, 2 and 2 percent of gross revenues for the three years in issue (Pet. App. B 22).

There is no dispute that petitioner preferred to lease rather than sell its machines for the reason that leasing was more profitable. Nevertheless, due to a variety of circumstances, petitioner was left with no alternative but to sell machines to those customers who wanted to purchase them (Pet. App. C 32). Most notably, the investment tax

credit, enacted in 1962, made it attractive for shoe manufacturers to purchase machinery rather than lease it. In addition, petitioner's principal competitor, United Shoe Machinery Corporation, was, in compliance with an antitrust decree, offering for sale machines it had previously only leased.[1] Thus, petitioner was forced to adopt a policy of selling if a customer were persistent. This policy, unlike sales procedures in the prior years, reflected the fact that sales personnel no longer sought the approval of the highest level of corporate management. Petitioner never refused to quote a sales price, nor to make a sale, where a customer was persistent (Pet. App. B 22, 23; Pet. App. C 32).

In its tax returns for the years in issue, petitioner reported the gain from the sales of machines previously on lease as long-term capital gain, under Section 1231 of the Code.[2] On audit, the Commissioner determined that the gain from these sales was taxable as ordinary income and determined deficiencies in the total amount of $159,081.72 for

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[1]See *United States* v. *United Shoe Machinery Corp.*, 110 F. Supp. 295 (D. Mass.), affirmed *per curiam*, 347 U.S. 521.

[2]The term "long-term capital gain" is defined in Section 1222(3) as "gain from the sale or exchange of a capital asset held for more than 6 months * * *." Section 1221 defines a "capital asset" as "property held by the taxpayer (whether or not connected with his trade or business)," but then proceeds specifically to exclude from capital assets five classes of property, including (Section 1221(2)) "property, used in his trade or business, of a character which is subject to the allowance for depreciation * * *." Section 1221 is, in turn, qualified by Section 1231, which permits long-term capital gain treatment of gain from the sale of depreciable proerty used in a trade or business and held for more than 6 months. However, both Sections 1221 and 1231 specifically exclude from capital gain treatment property held primarily for sale to customers in the ordinary course of trade or business. See Sections 1221(1) and 1231(b)(1)(B).

the years in issue. The district court denied petitioner's claimed refund (Pet. App. B 20-30). The court of appeals affirmed, holding that petitioner's sales had become an "accepted and predictable" part of its business activities, and that these assets were therefore held primarily for sale to customers in the ordinary course of its business. Accordingly, pursuant to the terms of Section 1231(b) (1) (B) of the Code, the gains in question were taxable as ordinary income (Pet. App. C 31-36).

ARGUMENT

1. Section 1231 of the Code permits favorable long-term capital gain treatment of gain from the sale of depreciable property used in a trade or business.[3] However, subsection (b)(1)(B) of that provision specifically excludes from such treatment "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, * * * ." Here, the record amply supports the district court's finding that from the point petitioner decided to sell its leased machines to customers who expressed a strong desire to buy them, it operated a business in which selling was an "accepted and predictable part" (Pet. App. B 24). Thus, because of the demand of its customers and competitive forces, petitioner decided to enter the market for selling shoe manufacturing machines. Once the policy decision was made to enter this business, it necessarily follows that the machines at issue here were held and sold in the ordinary course of that

[3]It is undisputed that petitioner's machines satisfy the general definition of a Section 1231 asset (Section 1231(b)(1), *viz.*, the machines in question were used in petitioner's trade or business, are subject to an allowance for depreciation, and were held for more than six months (Pet. 6-7).

business. The court of appeals correctly affirmed on this basis (Pet. App.C 34-35, 39).

Contrary to petitioner's contention (Pet. 6-10), the decision below does not conflict with this Court's decision in *Malat* v. *Riddell*, 383 U.S. 569. There, the taxpayers acquired property for the purpose of commercial development, intending a sale in bulk only in the event that their plans fell through, and only then "so they wouldn't get hurt." 383 U.S. at 571. The Court held that the latter purpose was not sufficient to require ordinary income treatment upon the sale of the property unless it was the principal purpose for which the property had been held. The Court remanded the case for findings in accordance with its opinion.

As the court of appeals held (Pet. App. C 34), *Malat* v. *Riddell* does not deal with the situation, common to contemporary business, where a company regularly engages both in selling and in leasing the same type of manufactured product. In such a situation, the taxpayer is engaged in two businesses, and the existence of the second business does not change the character of the income of the first—the regular income of both businesses is taxable as ordinary income. *Continental Can Co.* v. *United States*, 422 F. 2d 405 (Ct. Cl.), certiorari denied, 400 U.S. 819; *Hollywood Baseball Assn.* v. *Commissioner*, 49 T.C. 338, affirmed, 423 F. 2d 494 (C.A. 9), certiorari denied, 400 U.S. 848; *American Can Co.* v. *Commissioner*, 317 F. 2d 604 (C.A. 2). Consequently, the distinctions drawn between a "substantial" and a "principal" purpose in *Malat* v. *Riddell*, in the context of a single business, do not afford a basis for treating the "accepted and predictable" (Pet. App. B 24) sale of the machines here as occurring outside the

ordinary course of petitioner's business.[4] Petitioner may have entered the selling phase of its business reluctantly, and because it had "no choice" (Pet. App. B 23), but it was indisputably in that business. The mere fact that the volume of the leasing business exceeded the volume of the selling business does not convert regular business income from sales into capital gains.[5] Indeed, in a closely analogous case, *Recordak Corp.* v. *United States*, 325 F. 2d 460 (Ct. Cl.),[6] the Court of Claims rejected capital gains treatment for profit from the sale of an asset previously on lease where, as here, such sales represented a change in taxpayer's business operations. In so holding, it stated that (325 F. 2d at 463):

> "[P]rimarily" invokes a contrast, not between selling and renting, but between selling in the ordinary course of business and selling outside of that normal course. Accordingly, if the entrepreneur holds out his wares either for sale or for rental, the taxation of his business gain from sales does not depend upon a comparison of sales to rentals in the particular

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[4] Contrary to petitioner's argument (Pet. 12-13), the district court's discussion of *Corn Products Co.* v. *Commissioner*, 350 U.S. 46, does not afford a basis for further review because it was not relied upon by the court of appeals.

[5] Although petitioner preferred to lease its machines, it nevertheless held out its machines for sale in that customers knew they were available for purchase, price schedules were drawn up, and discounts were available to good customers (Pet. App. C 35). As petitioner's executive vice-president testified: " '* * * we didn't want to lose the sale to [our] competition' " (Pet. App. B 23).

[6] See *Malat* v. *Riddell, supra*, 383 U.S. at 571, n. 3, where the Court cited the *Recordak* decision in a manner which indicated that the situation considered there did not involve the "primarily" v. "substantially" question presented in *Malat*.

year. *S.E.C. Corp.* v. *United States, supra*, 140 F. Supp. at 719. Regardless of that ratio, the goods are held "primarily for sale to customers in the ordinary course of * * * trade or business" because they are regularly offered for sale to customers as part of the normal operation of the enterprise.

3. All of the other cases cited by petitioner (Pet. 11) to demonstrate a conflict with the decision below are not germane because they involve taxpayers engaged in a single business endeavor involving the holding of property with respect to which they had a "dual" purpose, sale and investment. Like *Malat*, they therefore turn on the meaning of the word "primarily" in the statutory phrase "primarily for sale to customers in the ordinary course of his trade or business."[7] Unlike those cases, however, here petitioner is engaged in two business, leasing and selling machinery. The machinery it sells, therefore, is "property held * * * primarily for sale to customers in the ordinary course of [its] trade or business" within the meaning of the statute.[8]

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[7]As petition er notes (Pet. 7), *Madat* v. *Riddell* involved Section 1221 of the Code, but the exclusionary clause of Section 1231(b)(1)(B) employs the identical terminology.

[8] Petitioner also asserts (Pet. 13-14) a conflict with *Philber Equipment Corp.* v. *Commissioner*, 237 F. 2d 129 (C.A. 3); and *Hillard* v. *Commissioner*, 281 F. 2d 279 (C.A. 5). But these cases, as the decision below observed (Pet. App. C 35-36), involved selling previously leased equipment only as "the natural conclusion of a vehicle rental business cycle" (237 F. 2d at 132). Here, the sales occurred not as the natural conclusion of the leasing cycle, but in response to customer demand, and in competition with petitioner's business rivals.

CONCLUSION

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

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AUGUST 1974.

DOJ-1974-08